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Supreme Court
FILED
SEP 29 1996

No. 96-409

# In the Supreme Court of the United States

OCTOBER TERM, 1996

SHELDON AND ANITA DROBNY, PETITIONERS

*v.*

UNITED STATES OF AMERICA

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT*

## BRIEF FOR THE UNITED STATES IN OPPOSITION

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15 pp

## QUESTION PRESENTED

Whether the putative purchase and lease of equipment in this case was a "sham" transaction lacking economic substance that is to be disregarded for federal income tax purposes.

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### OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-8) is unpublished, but the decision is noted at 86 F.3d 1174 (Table). The opinion of the Court of Federal Claims (Pet. App. 11-104) is reported at 32 Fed. Cl. 709.

### JURISDICTION

The judgment of the court of appeals was entered on April 10, 1996. The petition for rehearing was denied on May 29, 1996 (Pet. App. 9-10). The petition for a writ of certiorari was filed on August 27, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## STATEMENT

1. a. Petitioner Sheldon Drobny was an officer of Solargistics Corporation. That company, along with Geodesco, Inc., promoted a solar energy equipment leasing program (the S-G program). That program sought to take advantage of the tax incentives that are designed to encourage investments in alternative energy sources (Pet. App. 14-15, 19, 62, 66-69). The two companies that promoted this program shared several officers and directors (*id.* at 60-64).

As part of its 1982 investment program, Solargistics purchased uninstalled solar energy equipment from the manufacturer. This equipment had a list price of $6,060 and was purchased by Solargistics for $3,635 (Def. Exhs. 41A, 41, at 1-3). Solargistics offered to sell this equipment to investors for $20,000, with a down payment of $5,000 and the balance to be financed over 10 years at 9 percent interest. The annual payment on the 10 year note was $2,337.30 per year (Pet. App. 84; Jt. Exh. 1A, at 1). As part of each sale, Solargistics was required to pre-arrange a lease of the equipment to Geodesco at an annual rental of $2,487.30 (Pet. App. 18, 69). Geodesco, in turn, was to sublease the equipment to end-users. From the annual rent to be paid by the end-users, Geodesco was to make the investor's annual deferred purchase price payment ($2,337.30) to Solargistics and pay the balance of $150 directly to the investors (*id.* at 70-71, 83-84).[1]

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[1] The program also called for the investors to pay a one-time maintenance fee of $2,600. If the purchaser elected to give the end-user the option to purchase the equipment at the end of the lease term, however, only $600 of the $2,600 was

The promotional materials for the S-G program emphasized the income tax benefits of the transaction. The materials stated that, for a net cash outlay of $5,600, and with no further personal obligation, the transaction would yield a tax write-off of $15,600 to an investor in the 50% bracket in the year of purchase and additional benefits in the following years (Pet. App. 16-17, 69-70, 73-74, 84).

b. On December 27, 1982, petitioners purchased six units of solar energy equipment from the S-G program (Pet. App. 55; Pl. Exh. 8, at 1). On their joint federal income tax return for that year, petitioners claimed an investment tax credit of $43, an energy tax credit of $131, depreciation of $18,000 and maintenance expense of $15,600—all stemming from their participation in the 1982 S-G program (Pl. Exh. 16, at 7).

Some equipment that was ostensibly part of the 1982 program was not actually manufactured until 1983 (Pet. App. 89). Geodesco placed only 2 percent of the 1,521 systems that Solargistics had sold to its investors in 1982 by March 25, 1983, only 10 percent of the systems by the end of 1983 and only 25 percent by the end of 1984 (*id.* at 77-78, 84, 89). Geodesco never received any payments under the equipment rental agreements (*id.* at 78). Geodesco failed to pay the investors any net rent and did not make the annual loan installment payments of $2,337.30 to Solargistics. Instead, book entries were made by Geodesco and Solargistics purporting to evidence such payments (*id.* at 89).

Geodesco announced its default before investors made their 1984 purchases. Although the lease agree-

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payable at the time of purchase (Pet. App. 84-85; Jt. Exh. 1A, at 2).

ment gave the investors certain rights in the event of Geodesco's default—including the right to sue for rents due, future rents and liquidated damages—no investor ever pursued any of these remedies (Pet. App. 78). Geodesco offered the investors the chance to retrieve the equipment and to carry on the leasing business directly with any end-users. All of the investors, however, chose to have the equipment liquidated (*id.* at 79). When Geodesco was liquidated in 1988, each investor received $80 in cash for each $20,000 solar equipment unit, and Solargistics waived its lien and forgave the debt of $15,000 per unit (*id.* at 80-81).

2. The Commissioner of Internal Revenue disallowed the deductions and credits that petitioners claimed with respect to their S-G investment and determined that a deficiency of tax of $55,676.70 existed. The Commissioner also determined that additions to tax for negligence under 26 U.S.C. 6653(a)(1) (1982) and for valuation overstatement under 26 U.S.C. 6659 (1982) should be imposed. Petitioners paid the tax and penalties and filed an administrative claim for refund, which was denied.

3. Petitioners and other investors in the S-G program then brought this suit for refund in the Court of Federal Claims. After a trial, the court concluded that petitioners and the other investors were not entitled to the deductions and credits they claimed. The court found that the S-G program did not constitute a typical leveraged lease because of the lack of a bona fide third party and the "pervasive mutuality" of Solargistics and Geodesco (Pet. App. 27-32). After examining all of the relevant facts and circumstances, the court determined that "[w]ith regard to any objective reasonability of profit, the transactions were

without economic substance" (*id.* at 51). The court concluded that "the Solargistics-Geodesco program was a 'sham'" and is therefore not to be recognized for income tax purposes (*id.* at 53).

4. The court of appeals affirmed (Pet. App. 1-8). The court concluded that the lower court had applied the correct legal standard in determining whether the program was a sham (*id.* at 5-6). The court further held that it could "discern no clear error" in the lower court's findings regarding the facts and circumstances surrounding the transactions at issue (*id.* at 7) and in its conclusion that the S-G program was a sham (*id.* at 8).

The court of appeals rejected petitioners' contention that this case is "virtually identical" to *Sacks* v. *Commissioner*, 69 F.3d 982 (1995), in which the Ninth Circuit had held that leveraged leases of solar heating equipment were not "sham" transactions for tax purposes (Pet. App. 5). The court explained that the underlying transactions in this case "were distinguishable" from those involved in *Sacks* (*id.* at 6). In this case, unlike in *Sacks*, petitioners did not purchase the "equipment to lease to customers for a profit, but rather, paid a fee in exchange for tax benefits" (*id.* at 8).

## ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. It is fundamental that taxation turns upon the substance of a transaction, not its form. *Gregory* v. *Helvering*, 293 U.S. 465 (1935). As this Court has held in *Frank Lyon Co.* v. *United States*, 435 U.S. 561

(1978), courts are to honor the rights and duties agreed to by parties to "a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." *Id.* at 583-584.

Applying this Court's decision in *Frank Lyon*, the courts of appeals have focussed on whether the transaction had any practical economic effects other than the creation of income tax losses. See *Karr* v. *Commissioner*, 924 F.2d 1018, 1023 (11th Cir. 1991), cert. denied, 502 U.S. 1082 (1992); *Hines* v. *United States*, 912 F.2d 736, 739 (4th Cir. 1990); *Shriver* v. *Commissioner*, 899 F.2d 724, 727 (8th Cir. 1990); *Rose* v. *Commissioner*, 868 F.2d 851, 854 (6th Cir. 1989); *Sochin* v. *Commissioner*, 843 F.2d 351, 354 (9th Cir.), cert. denied, 488 U.S. 824 (1988). In making that determination, the courts examine the objective realities of the transaction—what was actually done, as opposed to what the parties purported to do. *Frank Lyon Co.* v. *United States*, 435 U.S. at 573; *Knetsch* v. *United States*, 364 U.S. 361, 366 (1960); *Gregory* v. *Helvering*, 293 U.S. at 469. See also *Dewees* v. *Commissioner*, 870 F.2d 21, 35 (1st Cir. 1989); *Kirchman* v. *Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989); *Yosha* v. *Commissioner*, 861 F.2d 494, 497 (7th Cir. 1988). When a transaction does not "appreciably affect * * * [the taxpayer's] beneficial interest except to reduce his tax" (*Knetsch* v. *United States*, 364 U.S. at 366), the transaction lacks economic substance and is disregarded for federal tax purposes (*Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334 (1945)). This approach has consistently been

followed in cases in which purported lease transactions have been found to be shams that have no effect for tax purposes. *E.g.*, *Rink* v. *Commissioner*, 47 F.3d 168, 172-173 (6th Cir. 1995); *Casebeer* v. *Commissioner*, 909 F.2d 1360 (9th Cir. 1990); *Shriver* v. *Commissioner*, 899 F.2d 724 (8th Cir. 1990); *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89, 94 (4th Cir. 1985).

2. The courts below had ample grounds for concluding that the lease arrangements involved in this case did not represent a genuine multiparty transaction with economic substance. Although Solargistics and Geodesco were ostensibly separate entities, the network of contracts between them was so inextricably intertwined that they did not constitute bona fide, multiparty leveraged leases. For example, while a bona fide leveraged lease typically involves three independent parties, in this case there was no unrelated third party who provided the source of financing for the purchase price of the equipment (Pet. App. 22; see Rev. Proc. 75-21, 1975-1 C.B. 715). As the trial court noted, the "attenuated course, from end user to installer to Geodesco to investor, of money needed to recoup the original cash investment and payment of the obligation to the lender" (Pet. App. 22) gave the transaction the appearance of a house of cards. For example, Solargistics wore two hats, standing in the shoes of both the seller and the lender. Geodesco also assumed multiple functions as lessee and sublessor. As the trial court aptly observed, "[p]rotections provided to an equipment buyer in a normal leveraged lease by a third party lender, and clearly defined responsibilities of the lessee, were combined and muddled in the Solargistics-Geodesco program" (*id.* at 25). In concluding that a bona fide economic transaction

was absent in this case, the court emphasized that all of the transactions were controlled by small, closely-held companies with limited resources, whose shares were owned by one or two individuals and which were operated jointly by a "narrow group of promoters" (*id.* at 26).

The courts below were also correct in concluding that the transactions at issue lacked economic substance due to the absence of an objectively reasonable possibility of any profit aside from tax benefits. The record plainly reflects that the venture had no realistic possibility of generating a profit. Even under the most optimistic assumptions, the net positive cash flow could not exceed $1,400 over 10 years (Pet. App. 86). As the courts correctly concluded, this program was designed to reap tax benefits, not to generate any genuine economic return (*id.* at 73).

The highly-inflated, debt-financed purchase price of the equipment further indicated that the transactions lacked economic substance. Nonrecourse debt that greatly exceeds the value of the underlying asset is not treated as true debt for tax purposes because a borrower could prudently abandon the property rather than repay the debt. *Estate of Franklin* v. *Commissioner*, 544 F.2d 1045, 1048-1049 (9th Cir. 1976). The use of a highly inflated price based on deferred debt that is *unlikely* to be repaid also indicates a lack of economic substance. *Gilbert* v. *Commissioner*, 53 T.C.M. (CCH) 461, 469 (1987), aff'd, 858 F.2d 744 (11th Cir. 1988) (Table); *Flowers* v. *Commissioner*, 80 T.C. 914, 937 (1983). In this case, three-quarters of the purchase price of each unit of equipment was paid by means of a note to be repaid solely from rents and with the equipment as the sole collateral (Pet. App. 84). The price investors were to

pay ($20,000) greatly exceeded not only the manufacturer's list price of $6,060 but, even to a greater extent, the price Solargistics actually paid for the equipment ($3,635). The debt that was created served no function other than to generate increased tax benefits.

3. The court of appeals correctly rejected (Pet. App. 6) petitioners' contention (Pet. 12) that the facts of this case are comparable to those of *Sacks* v. *Commissioner*, 69 F.3d 982 (9th Cir. 1995), rev'g 64 T.C.M. (CCH) 1003 (1992). Like this case, *Sacks* involved a sale and leaseback of equipment eligible for the energy credit. In *Sacks*, however, the price paid for the solar water heaters "was about the middle of the range of prices" for comparable equipment being sold directly to homeowners (64 T.C.M. (CCH) at 1008), notes the taxpayer gave in partial payment were recourse in form (*id.* at 1027) and the equipment was actually leased to homeowners (*id.* at 1029 n.15). The Tax Court found the arrangement in *Sacks* to be a sham because the anticipated cash flow had a negative present value over the life of the equipment. The Ninth Circuit reversed, however, noting that, unlike the typical tax shelter, no grossly inflated purchase price was involved and that, since the promissory notes were recourse in form, the taxpayer was personally liable for payment (69 F.3d at 988-990).[2]

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[2] Contrary to petitioners' contention (Pet. 21 n.4), the trial court in this case did not make any finding as to whether they purchased the equipment "on fair terms, at fair market value," as was true in *Sacks* (69 F.3d at 990). And, although the promotional materials may have advertised a net rent payment to the investors of $150 (annual rent of $2,487.30, less annual deferred purchase price of $2,337.30, which the court found to

As the court of appeals correctly concluded (Pet. App. 5-8), the present case is distinguishable from *Sacks*. In *Sacks*, unlike in the present case, there was no "pervasive mutuality" among the parties to the arrangement (Pet. App. 27). Nor, unlike in *Sacks*, was the program in this case operated as a genuine business. Unlike in *Sacks*, relatively little equipment involved in the S-G program was leased to end-users. Compare 69 F.3d at 988 with Pet. App. 7, 71-72, 77-78. And, unlike in *Sacks*, the record in this case does not even show that the equipment actually existed when it was ostensibly purchased. Compare 69 F.3d at 988 with Pet. App. 88-89. Moreover, the option that petitioners gave to purchase the solar equipment (Jt. Exh. 1, at 39-40)—a feature not present in *Sacks*—gave away the opportunity to reap any profit that could be realized from the underlying transactions. Thus, unlike the taxpayer in *Sacks*, petitioners cannot contend that the transactions at issue embodied any bona fide expectation of profit apart from tax benefits. See 69 F.3d at 988.

The court of appeals thus properly concluded that the decision in *Sacks* is inapposite because of the factual distinctions that exist between the two cases. That factual determination does not warrant further review.

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be "minimal" (Pet. App. 83)), Geodesco failed to pay the investors any net rent (*id.* at 88-89).

## CONCLUSION

The petition for writ of certiorari should be denied.
Respectfully submitted.

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NOVEMBER 1996